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Recent Developments in Monetary Policy

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Introduction

This talk

- I will discuss some recent developments in U.S. monetary policy.
- Recent FOMC policy announcements have been followed by a substantial rise in Treasury yields.
- Has such a rise been justified?
- I will review several possible justifications.
- I will conclude that a key justification is that there is currently more optimism about future economic performance than previously.
- However, we should be careful: Optimistic forecasts have consistently been wrong during the last several years.

Recent Developments

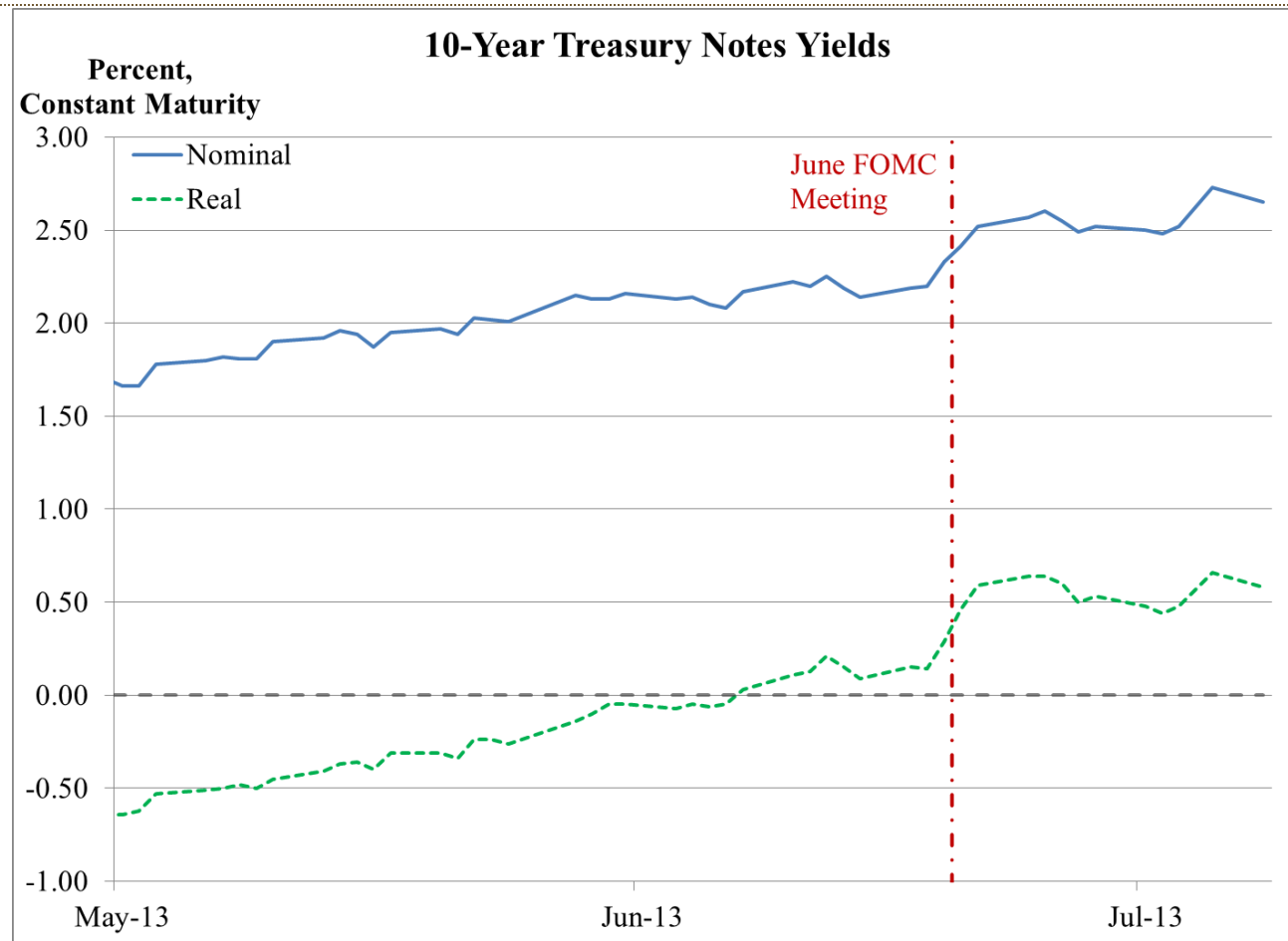
The components of current policy

- Current U.S. monetary policy has three components: The policy rate, forward guidance, and asset purchases.
- The policy rate itself has been near zero since December 2008 and remains there today.
- There are two “unconventional” aspects to policy:
 - Forward guidance is a promise to keep the policy rate near zero at least until unemployment falls below 6.5 percent or inflation rises above 2.5 percent.
 - Asset purchases of Treasuries and MBS are continuing at \$85 billion per month until there is substantial improvement in the labor market.

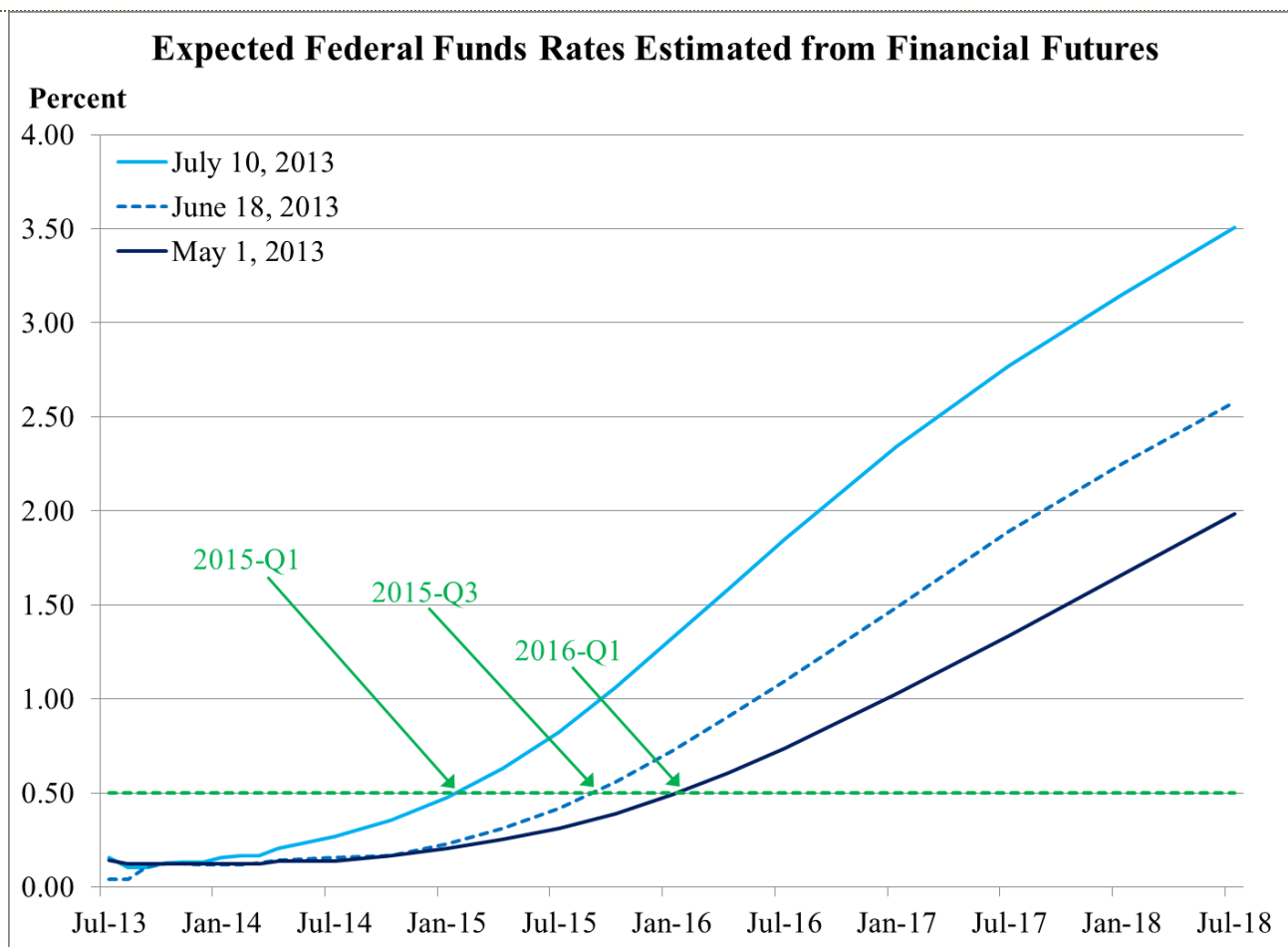
The June FOMC meeting

- The FOMC recently authorized Chairman Bernanke to discuss possible plans for reducing the pace of asset purchases.
 - The so-called “tapering of QE.”
- The financial market reaction has been substantial, even though the Committee has not actually changed any policy settings at this point.

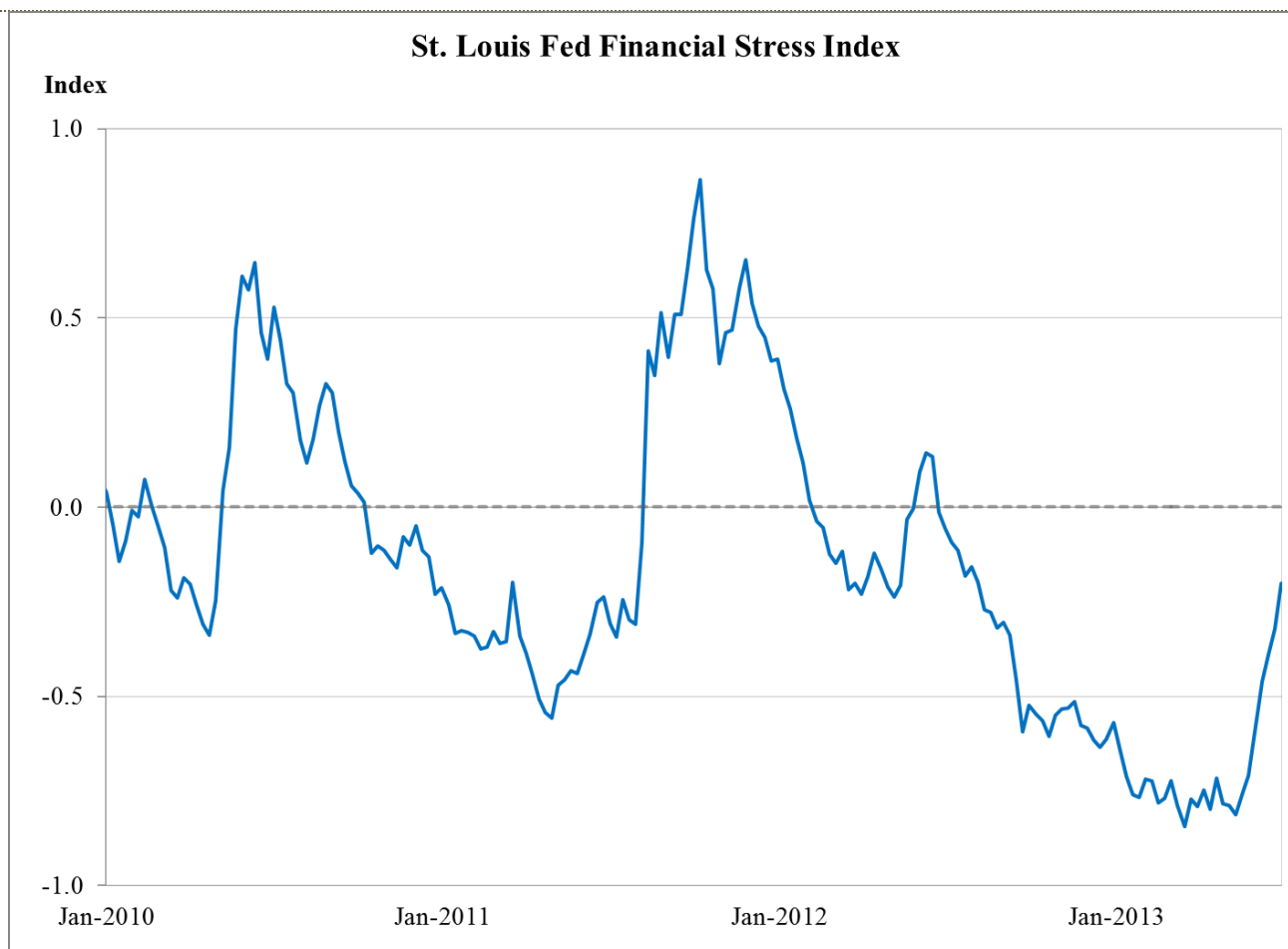
Nominal and real yields



The expected policy rate path



St. Louis Fed Financial Stress Index



A sharp increase in Treasury yields

- Has the bond market reaction been warranted?

Three possible justifications

- Has the economy improved substantially?
 - Some measures of labor market outcomes have improved since last September, but others have not.
 - Real GDP growth has been slow over the last three quarters.
- Have inflation expectations increased?
 - No.
- Is there optimism for improved prospects for the U.S. economy?
 - Yes, but given recent forecasting records, we may want to reserve judgment on this until better data arrive.

Plan of the talk

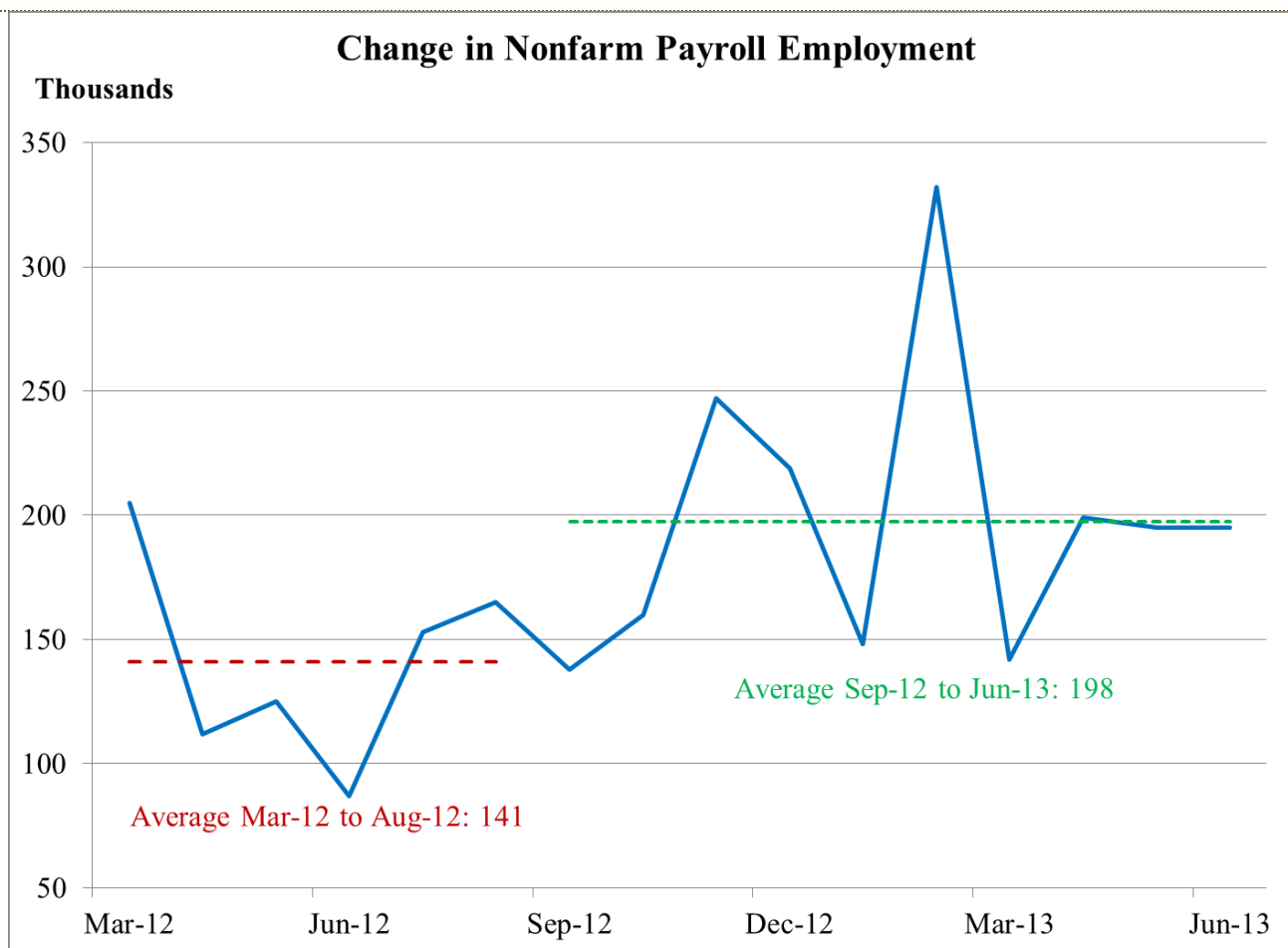
- Let's consider each of these possible justifications in more detail.
- At the end, I will discuss recent global developments in monetary policy.

The Evidence on Current Economic Performance Is Mixed

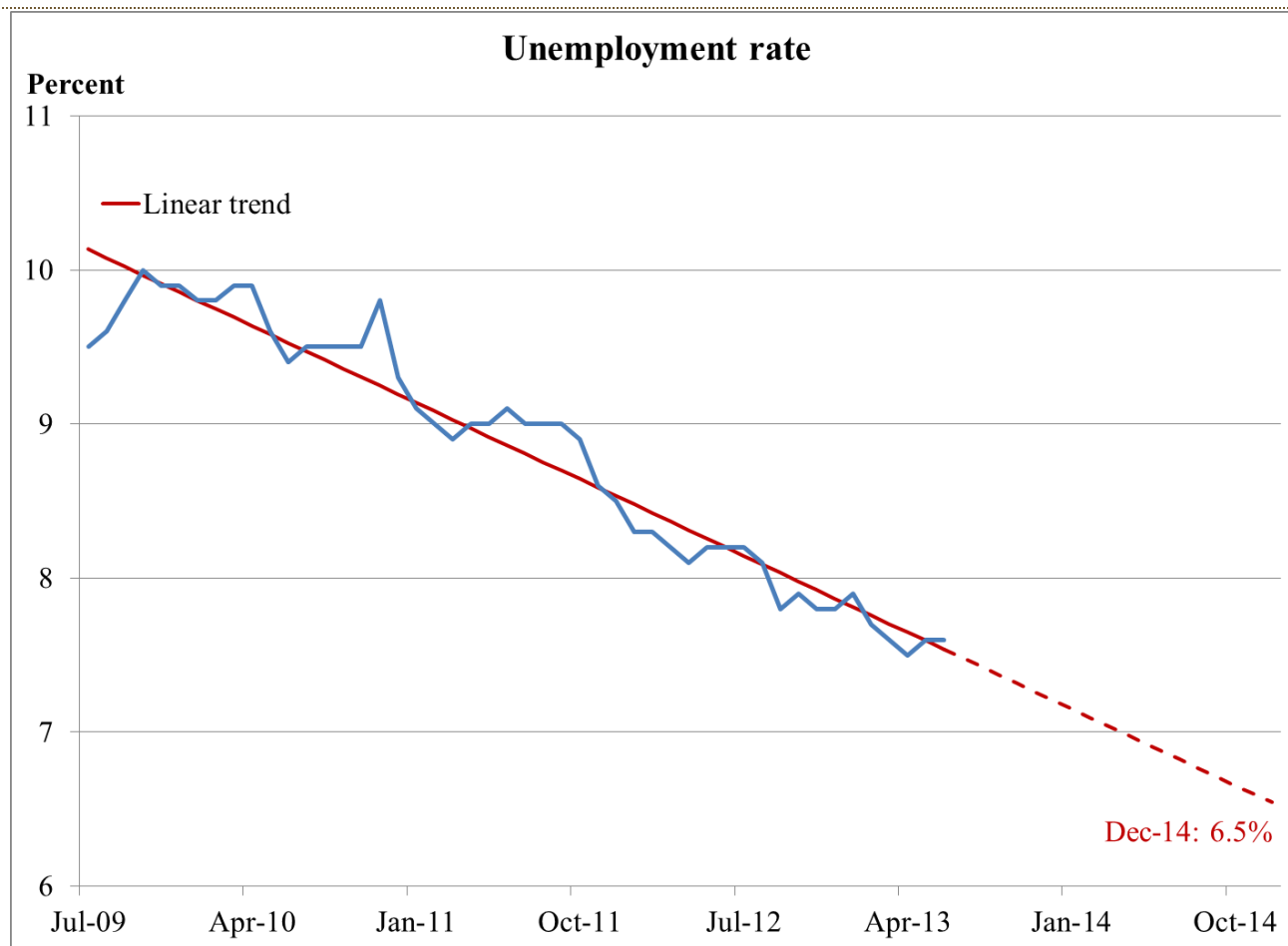
Current macroeconomic performance

- Bond yields would naturally rise if macroeconomic performance was stronger than expected.
- It is possible to make this case, but the evidence is mixed.
- By some measures, labor markets have improved since last September, the date at which QE3 was launched.
- But other measures suggest otherwise.
- Real growth in gross domestic product, for instance, has been slow.

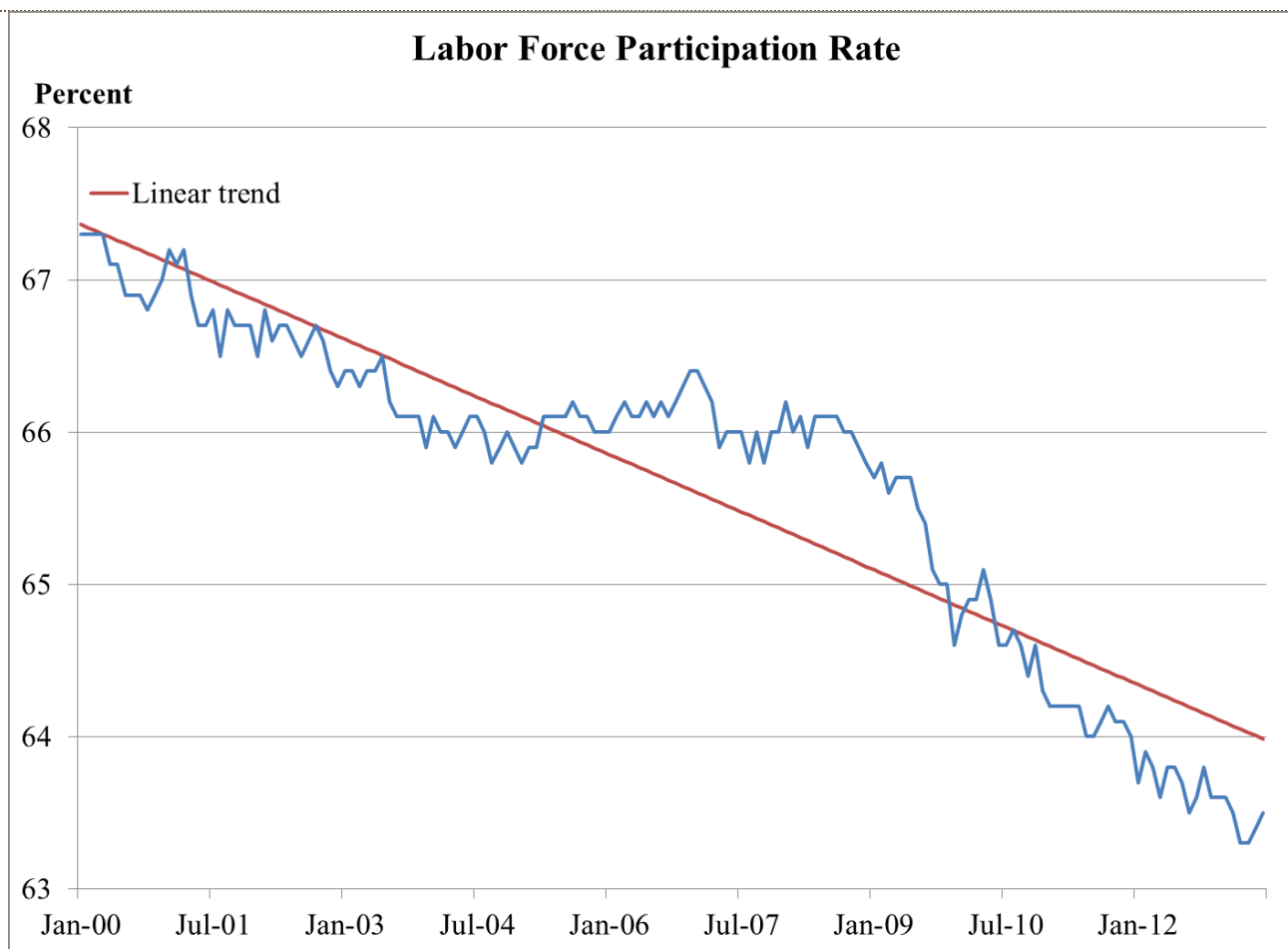
Nonfarm payroll employment



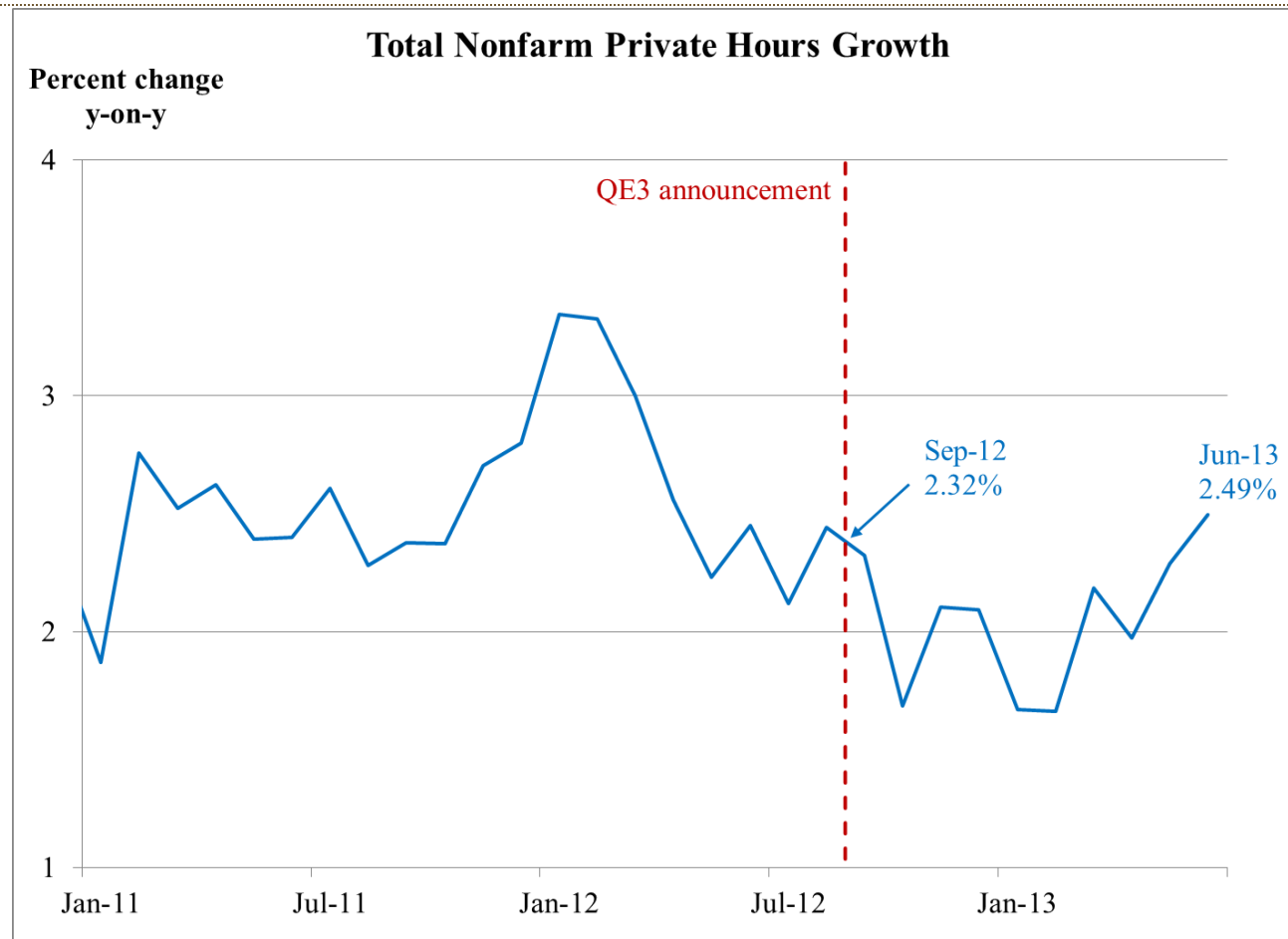
Unemployment rate



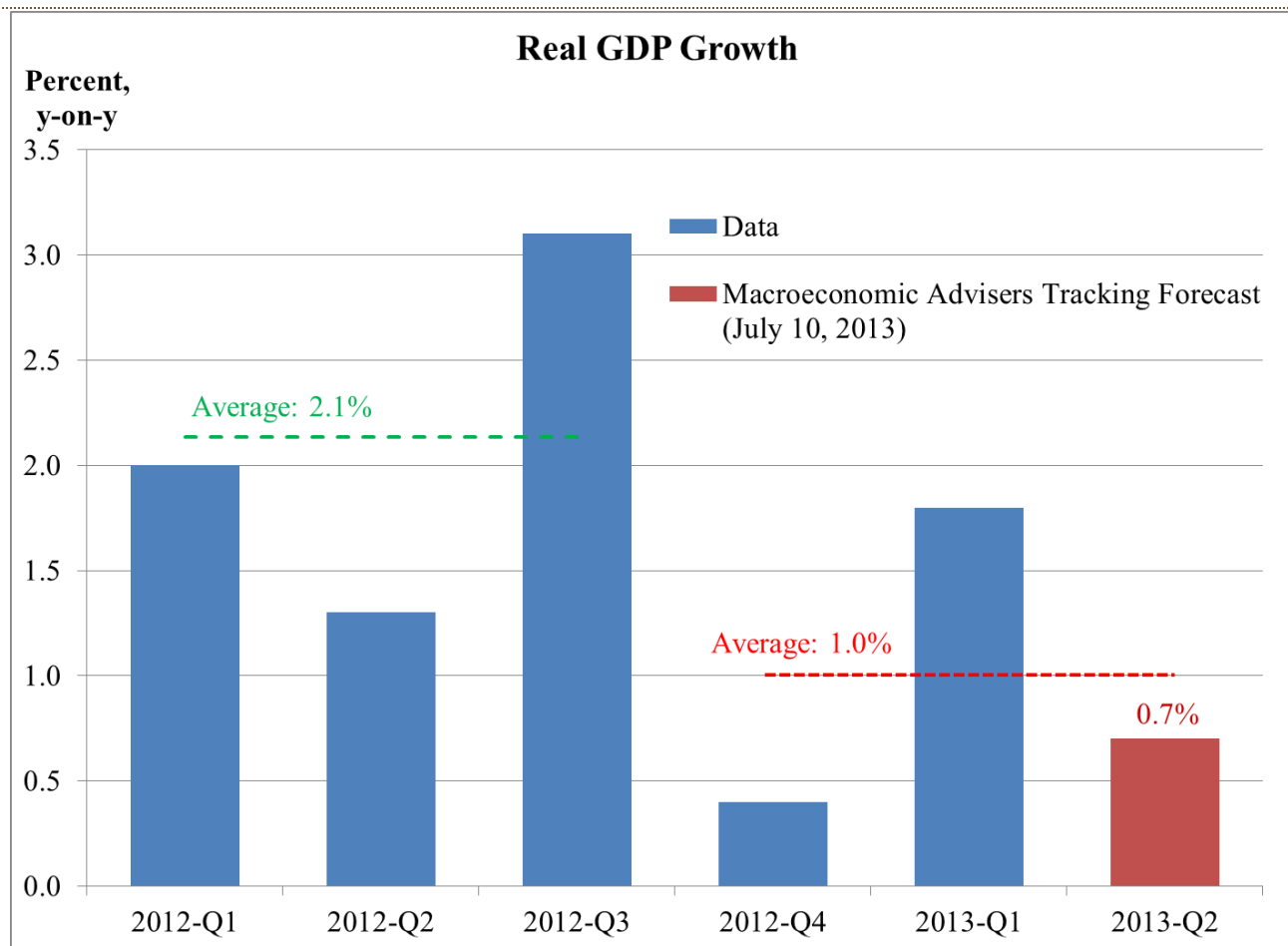
Labor force participation rate



Growth in total nonfarm private hours



Real GDP growth



Better real performance

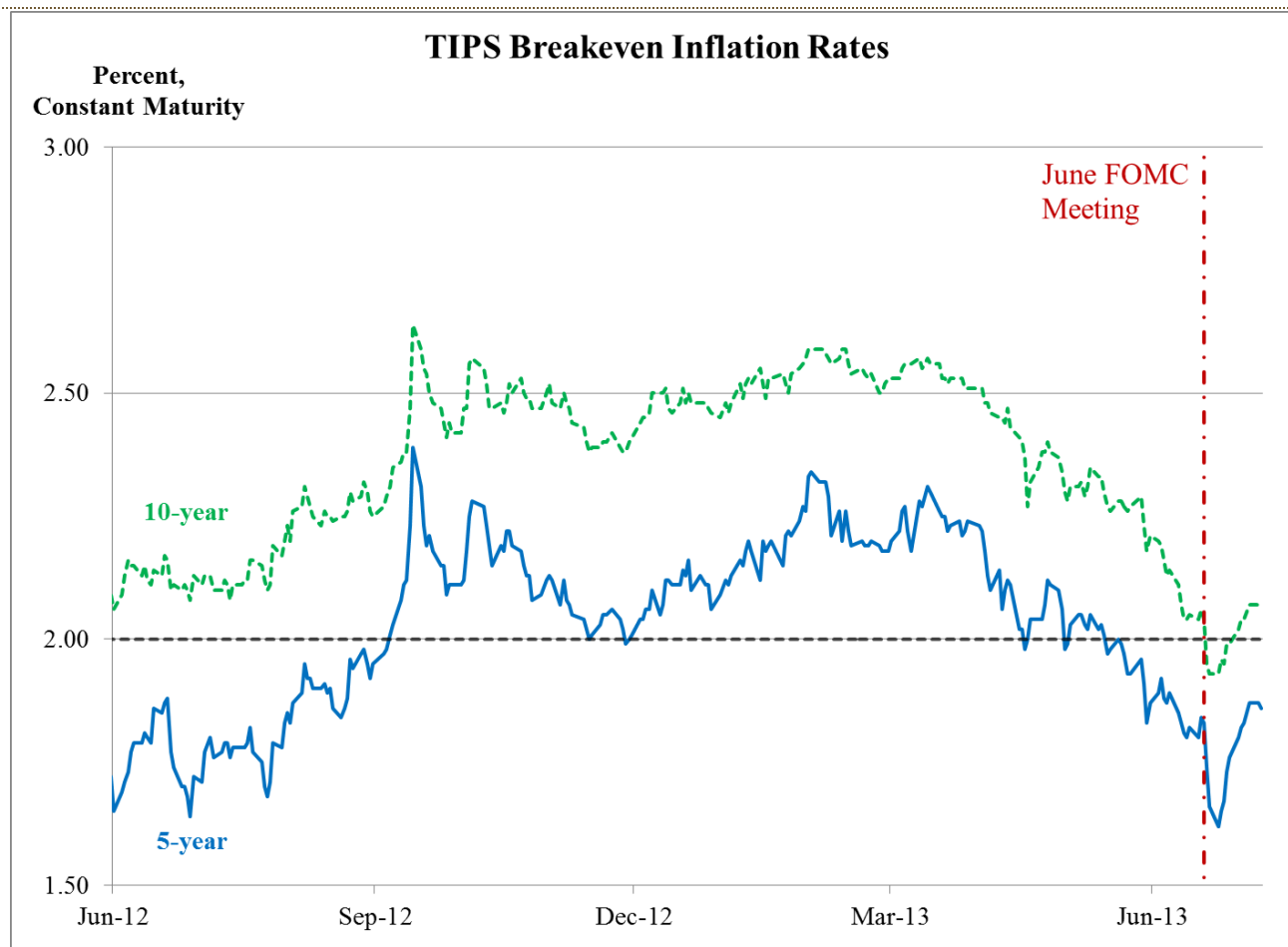
- Can the rise in yields be justified by better data on the U.S. economy?
- Probably not.
- While some measures of labor market performance look better, others, including hours worked and labor force participation, do not.
- Real GDP growth is slow.

Inflation Is Low

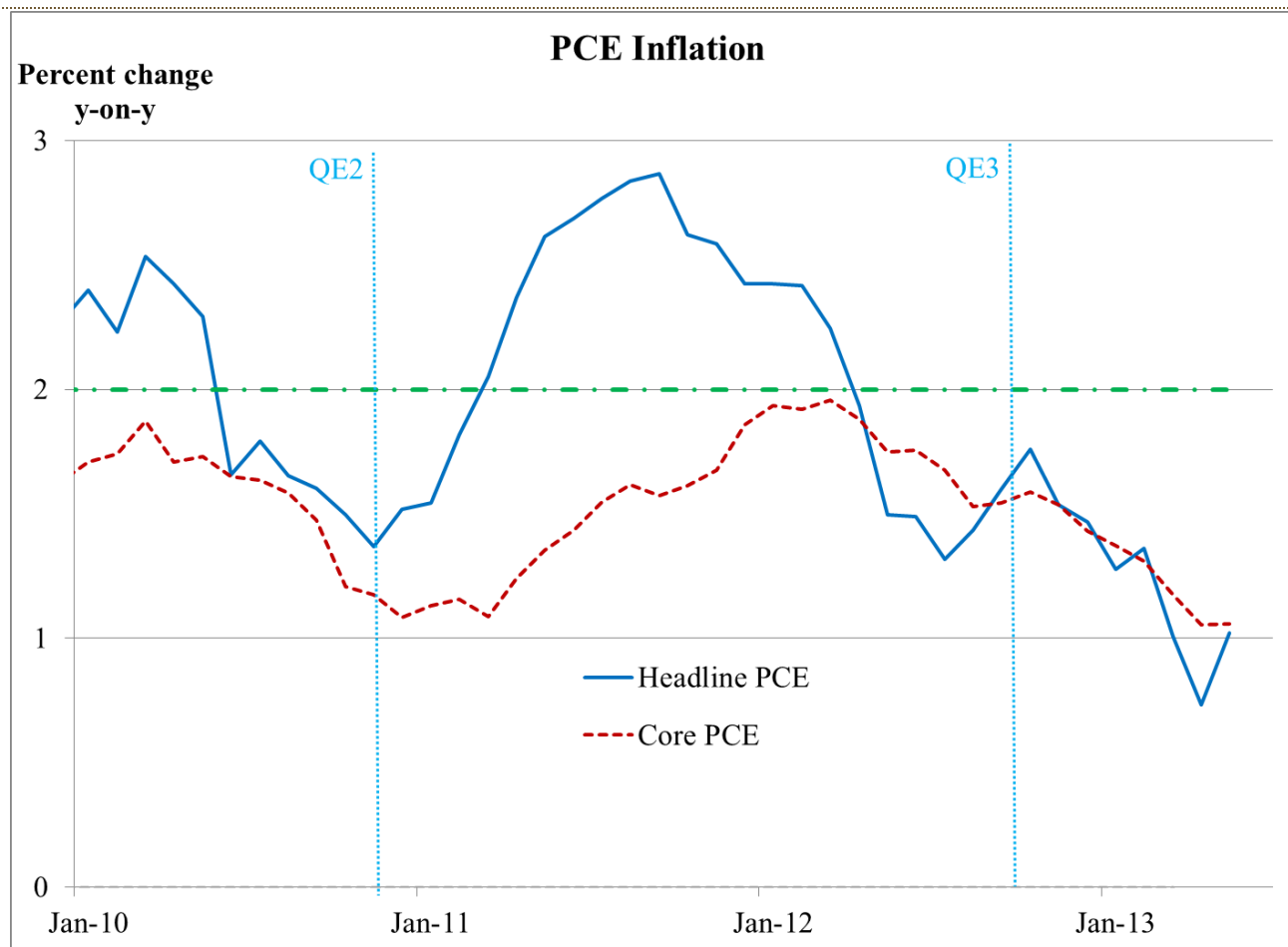
Increased inflation expectations

- Nominal bond yields could rise in reaction to higher expected inflation.
- This would be a traditional reason to tighten monetary policy.
- However, current inflation is low and the immediate reaction to the FOMC announcement was to send TIPS-based inflation expectations lower.
- Accordingly, the increase in bond yields is not associated with an increase in inflation expectations.

Inflation expectations declining



PCE inflation



Why has inflation been low?

- We do not have a good explanation, so we should be careful.
- One sketch of a theory:
 - Commodity prices globally have been soft over the last year.
 - This may be due in part to the recession in Europe, coupled with slower-than-expected growth in China.
 - This may have fed through to core price inflation in the U.S.
- Core PCE inflation near 1 percent measured from a year earlier is near the lower edge of acceptable outcomes.

Optimism

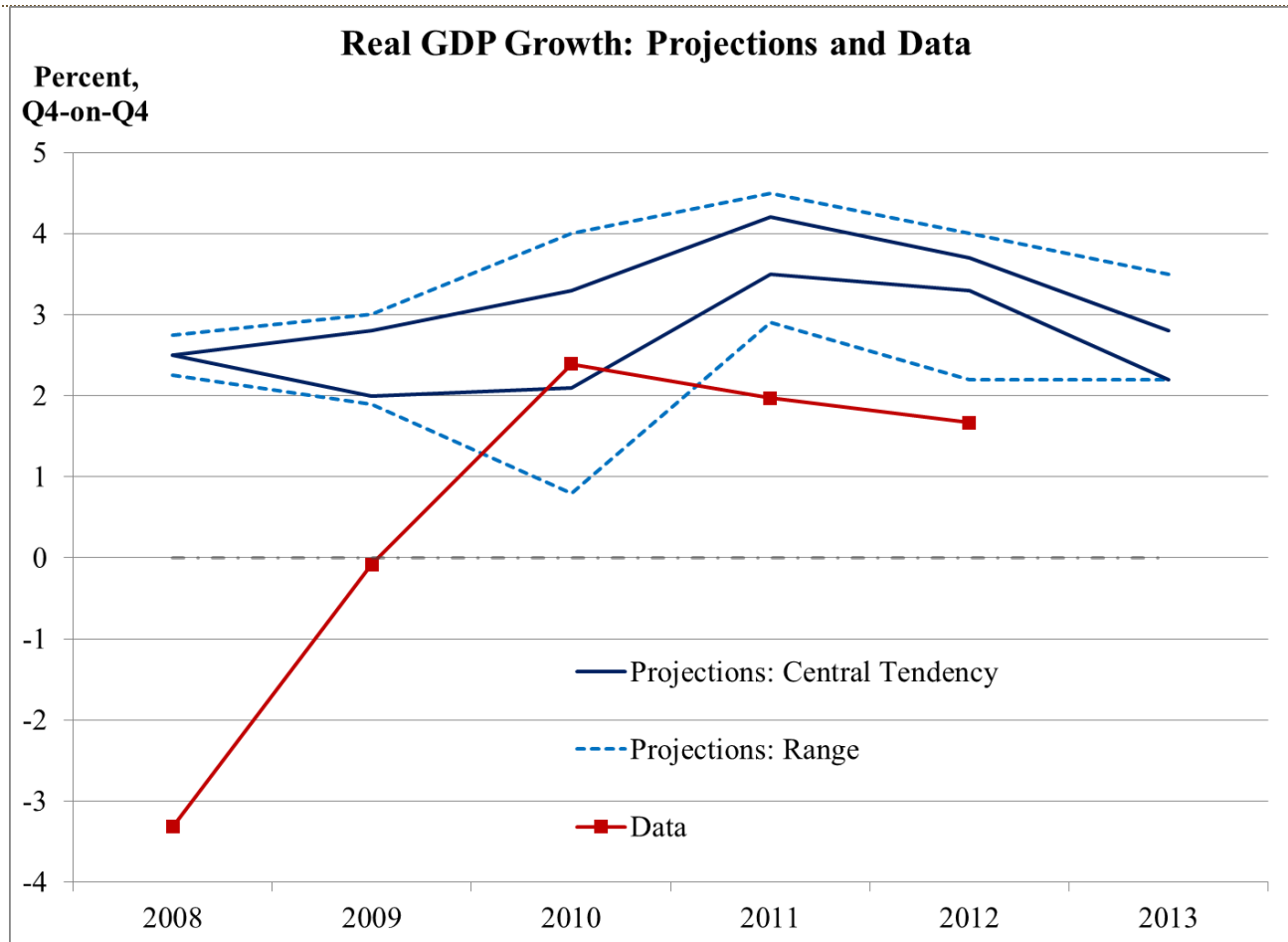
The case for optimism

- Rates would naturally rise if future macroeconomic prospects became brighter.
- The case for an optimistic view of future U.S. macroeconomic performance is simple.
- In a nutshell, many, but not all, of the factors slowing the U.S. economy down are waning.
 - Real estate markets are improving, equity markets have rallied, the European sovereign debt crisis remains subdued for now, U.S. fiscal brinksmanship has been less of a problem, and household deleveraging is further along.

The problem with optimism

- I have been optimistic in my own forecasts for the U.S. economy over the last several years.
- In part, this is because empirical models suggest that, with the current configuration of data and policy settings, rapid growth lies just ahead.
- I have tempered these forecasts with an explicit recognition that economies tend to grow more slowly following a financial crisis.
- Still, I have generally been too optimistic.
- Given this experience, I think caution is warranted in taking policy action based on forecasts alone.

Forecast errors



Source: Federal Reserve Board. Economic projections of Federal Reserve Governors and Reserve Bank presidents in the Monetary Policy Report to the Congress from the previous July.

Global Alignment

Global policy alignment improves

- The Euro area has recently been in recession, while the U.S. has been growing.
- However, the ECB has not adopted “unconventional” approaches to monetary stabilization policy, such as QE or forward guidance.
- I commented on possible approaches in Europe in May 2013.*
- The ECB recently decided to go ahead with a forward guidance initiative.
- This may provide more support for the Euro-area economy and ultimately for the U.S., and so may be a bullish factor for the U.S.

Conclusions

Conclusions

- Recent FOMC decisions have met with a substantial rise in Treasury yields.
- I have suggested that a possible justification for the rise in yields is increased optimism concerning future U.S. macroeconomic performance.
- However, given recent forecasting performance, we should be careful in using an optimistic forecast to justify current policy decisions.
- A more prudent approach would be to wait to see if better macroeconomic outcomes materialize in the months and quarters ahead.



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